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RUEHFR/AMEMBASSY PARIS 0045
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RUEHLO/AMEMBASSY LONDON 0168
RUEHML/AMEMBASSY MANILA 1425
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RUCPODC/USDOC WASHDC 1346
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STATE PASS USTR
STATE FOR EAP/CM, EB/IFD AND EB/TPP
USDOC FOR ZHEN-GONG CROSS
TREASURY PASS USEDS TO IMF AND WORLD BANK
MANILA FOR USED TO ADB
LONDON FOR USED TO EBRD

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SUBJECT: Mongolia's Economy Still Running Strong

11. SUMMARY AND COMMENT: Mongolia's economy continued strong growth in the first half of 2007 and, according to local analysts, will likely meet expectations of 7% to 8% GDP growth this year. High copper prices and increased tax receipts bolstered Government revenues. The Ministry of Finance is now altering its 2007 budget predictions, expecting total revenue of US\$1.379 billion, expenditures of US\$1.488 billion and a targeted budget deficit of 3.7% of GDP, which contrasts with 2006's year end budget surplus of 7% of GDP. Trade turnover rose 38.7% over last year, but imports have outpaced exports creating a trade deficit of US\$32.2 million. Despite IMF calls for the Bank of Mongolia to reign in broad money growth (M2), money supply has climbed, increasing 36.7% from a year ago. Mongolia's economy, overly dependent on its commodity exports, is easily threatened by external shocks such as weather conditions and dramatic fluctuations in commodity prices. The increase in tax revenues after enactment of sizable tax cuts is a welcome sign of increased business development and reduced tax evasion. END SUMMARY AND COMMENT.

Government Revenues Increase

12. The Ministry of Finance (MOF) submitted revised budget figures to the State Great Hural (parliament) recently that took into account stronger than expected economic growth for the first six months of 12007. Increased revenues from copper sales and an unanticipated up-tick in tax receipts brought in revenues of US\$634.5 million. This, coupled with budgeted expenditures of US\$550 million for the same time period, has created a budget surplus of US\$84.3 million for the first half of 2007. The MOF now predicts that year end government revenue could exceed initial budget estimates by as much as US\$200 million with government revenue figures expected to total US\$1.379 billion. To take advantage of the windfall, the MOF is revising expenditures upward to US\$1.488 billion, yielding a targeted budget deficit of 3.7% of GDP. The MOF believes that Mongolia is well on its way to 7% and 8% GDP growth this year, and some optimistic analysts now suggest that 9% is not be out of the

question.

High Copper Prices, Increased Tax Revenue

13. According to MOF Minister N. Bayartsaikhan, price growth for copper on the world market generated most of the additional income for the state budget. When calculating the budget last year, the GOM had estimated copper prices at US\$6000 per ton, but fluctuations have seen the price drop to as little as US\$5200 per ton and rise to US\$8225 as recently as May. The GOM has now revised its copper price estimation upward to US\$6600 per ton, yielding an additional US\$44 million to state coffers (US\$3.9 million in corporate income tax, US\$37.6 million from the windfall profits tax and US\$2.6 million in royalties).

14. Furthermore, tax revenues are up a whopping 33.3% over the same period last year (taxes on foreign trade increased by 35.2% and excise tax revenue was up 27.7%) despite doomsayer predictions that tax collections would plummet after enactment of tax cuts this year. The MOF had originally predicted a loss of US\$129 million in tax revenue; however, the newly simplified tax regime, praised by both local and international businesses, has increased the country's tax base by spurring business development and drawing many grey-marketers into the legitimate economy.

GOM to Spend Budget Windfall on Social Programs

15. The GOM intends to redistribute much of the additional income through increased spending on social welfare programs. One-time government grants to newlyweds of approximately US\$500 and to newborns of \$US100 are providing incentives for more and more

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Mongolian's to "get in the family way." Marriages are expected to reach 35,000 by the end of the year (triple the pre-grant average of approximately 12,000 per year) and births in the first six months of 2007 are up 8.8%. Local analysts also note this year is considered especially auspicious for newborns. To cover these and other unplanned increases, the MOF revised this year's budget adding US\$14 million into the already weighty social expenditures budget.

Trade Turnover Increases: Imports Outpace Exports

16. Although Mongolia saw its first trade surplus in a decade in 2006, the first half of 2007 revealed a trade deficit of US\$32.2 million (exports of US\$836.2 million and imports US\$868.4 million). Nevertheless, total external trade turnover increased by 38.7% to US\$1.7 billion. Exports rose by 38.7% and imports by 40.7%. Mineral product exports increased by US\$163 million. The volume of exported copper, one of Mongolia's three main exports, decreased by 0.2% or 0.7 thousand tons, but the value of copper concentrate increased by 37.8% from 2006 to \$1,198.7 per ton in 2007. Mineral product imports (mostly fossil fuels from Russia) increased by US\$71.9 million. Overall, textiles exports continued to decline, decreasing by US\$3.6 million. Cashmere exports were the exception, rising by US\$11.4 million from the same period last year.

Industrial Output Increases, Led by Manufacturing

17. Total industrial output in the first half of 2007 equaled US\$361 million at constant prices 2000; an increase of more than 13.2% over the same period last year. The manufacturing sector grew 29.2%. By contrast, the mining and quarrying sector registered only 6.2% growth.

CPI Up 6.4% in 2007

18. In June 2007, the consumer price index increased by 1.8% compared with previous month, by 6.3% from the corresponding period of previous year, by 6.4% from the end of previous year and by 12.7% compared with reference period (December 2005). Prices of foodstuffs

increased by 2.2% and transport by 2.2% and were major contributors to the increase in the overall index of 1.8%. Prices of clothing, footwear increased by 0.1%; housing, water, electricity and fuels by 0.2%, and health by 0.4%. Prices of furnishings and household equipment, communication, miscellaneous goods and services and recreation and culture decreased by 0.3-2.0%. Prices of goods and services of other groups remained stable.

Money Supply Still Growing Rapidly

¶9. According to the Bank of Mongolia, rapid growth in borrowing, a booming economy and wage increases meant that at the end of June of 2007 money supply (broad money, or M2) had increased by 2.5% or US\$543 million from the previous month, reaching US\$1.75 billion, an increase of 36.7% or US\$466 million compared to June, 2006. Currency in circulation decreased by 0.9% or US\$2.6 million compared to May of 2007, reaching US\$275 million (an increase of 32.5% - US\$67.6 million - over June 2006).

¶10. Time saving deposits increased by 5.2% or US\$40.4 million over the previous month, and by 78.5% or US\$357.4 million compared with June of 2006, reaching US\$812.4 million. Foreign currency deposits increased by 2.5% or US\$6.7 million reaching US\$272.7 million over the previous month: a decreased of 17.2% or US\$56.7 million compared with June of 2006.

Number of Loans Increases

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¶11. At the end of June 2007 the remainder of loans outstanding increased by 52.3% compared with June of 2006, reaching US\$1.377 billion, of which loans to the private sector increased by 63.4%, personal loans increased by 49.8%, other sectors increased by 21.0%, other financial corporations increased by 74.6% and public sectors decreased by 23.5% respectively. Meanwhile, principals in arrears increased by 77.8% and substandard, doubtful, loss loans increased by 2.5%. The amount of non-performing loans (NPL) reached US\$53 million - 3.9% of total loans outstanding. The percentage of NPL to the total has been shrinking as more loans are issued. Mongolia's loan market is particularly sensitive to commodity price fluctuations as the number of defaults would skyrocket should the economy sour on dropping copper or gold prices. This sector could easily prove to be the economy's Achilles' heel.

Passenger Traffic Up, Freight Down

¶12. Volumes of freight traffic decreased by 2.1% while passenger traffic increased by 4.2% from the same time last year. Much of the decrease in freight traffic can be attributed to Mongolia's inability to process and transport increasing imports due to an aging railroad. Analysts point out that imports through Mongolia's southern boarder Zamiin Uud are up 53% over last year, but dilapidated locomotives and a shortage of functioning rolling stock have prevented efficient importation of the products into the country.

¶13. The number of international passengers coming to Mongolia increased 25.4% from the same period last year, a sizable jump over the previous year's muscular increase of 29.5% over 2005, attributed to celebrations of Mongolia's 800th anniversary. Tourist numbers to Mongolia have increased steadily over the past 5 years rising from a post SARS low of about 15,000 tourists to an expected 40,000 visitors in 2007. Officials hope to increase numbers even further next year by drawing tourists from the Beijing 2008 Olympics.

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